Hills v. Commissioner: The Meaning of "Compensated for by Insurance" in Internal Revenue Code Section 165 (a)

I. Introduction

In 1976 the taxpayers' lakefront home in rural Georgia was burglarized for the fourth time in eight years.[1] They did not claim insurance reimbursement for this theft, as they had for the previous three, because they feared that their policy would not be renewed. Nonrenewal meant losing not only their theft coverage, but also their fire insurance coverage.[2] Instead, the taxpayers claimed a casualty loss deduction pursuant to section 165 of the Internal Revenue Code (I.R.C.).[3] Section 165(a) allows a deduction for any loss sustained if "not compensated for by insurance or otherwise."[4]

The Commissioner of Internal Revenue (Commissioner) issued a statutory notice of deficiency, determining that the taxpayers were "not entitled to deduct a theft loss when . . . covered by an insurance policy and no claim for recovery was filed under the policy."[5] Thereafter, the taxpayers petitioned the Tax Court, contending that the deduction should have been allowed since they were in the same position as a taxpayer who had no insurance.[6]

The taxpayers did not allege nor attempt to prove that the insurer denied liability.[7] In fact, they conceded "that reimbursement for this loss could probably have been received from the insurance company had a claim been filed."[8] The Tax Court allowed the deduction, holding that for the purposes of section 165(a), "compensated" does not mean "covered."[9] Rather, the court said that under "the normal, everyday meaning of the word, . . . [t]o compensate denotes 'to pay' or 'to make up for.'"[10] Since the taxpayers did not benefit from any actual recoupment for the loss,[11] the Tax Court reasoned

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1. Hills v. Commissioner, 76 T.C. 484, 485 (1981), *appeal docketed*, No. 81-7668 (11th Cir. Aug. 17, 1981).
2. Brief for Petitioners at 2.
3. 76 T.C. 484, 485 (1981).
4. I.R.C. § 165 (1978) provides:

(a) GENERAL RULE.—There shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise.

. . . .

(c) LIMITATION ON LOSSES OF INDIVIDUALS.—In the case of an individual, the deduction under subsection (a) shall be limited to—

(1) losses incurred in a trade or business;

(2) losses incurred in any transaction entered into for profit, though not connected with a trade or business; and

(3) losses of property not connected with a trade or business, if such losses arise from fire, storm, shipwreck, or other casualty, or from theft.

5. Brief for Respondent at 5.
6. 76 T.C. 484, 486 (1981).
7. *Id.* at 492 (Sterrett, J., dissenting).
8. Brief for Petitioners at 2.
9. 76 T.C. 484, 486 (1981).
10. *Id.* at 486–87.
11. *Id.* at 487.

that the loss deduction should be granted, as if the taxpayers had been uninsured.[12]

The Tax Court apparently felt sympathy for the Hillses, who were virtually in a no-win situation. They could either file the small-theft claim and risk losing the catastrophic coverage on the house, or not file the claim and pay for the loss themselves while attempting to recoup some of it through an income tax deduction. Furthermore, the Hillses' fear is not without support. One New York investment counselor advises his clients not to insure against small losses because even though "[u]nderwriters expect to pay off on the target event, [they] hate a series of small claims that roughly offset the premium payments."[13] Consequently, repeated claims will result in policy cancellations or higher premiums.[14]

A rational businessperson surely would forego a $1,000 claim to keep $100,000 of catastrophic coverage. But the business taxpayer who takes an income tax deduction without filing an insurance claim can be criticized for double deducting since insurance premiums are deductible as a trade or business expense.[15] However, individual taxpayers, like the Hillses, could not be so criticized, because their insurance premiums are not deductible since they are a personal, living, or family expense.[16] Nevertheless, serious income tax problems arise from allowing individual taxpayers to forego claiming insurance coverage and to take income tax deductions instead.

This Case Comment demonstrates that the better interpretation of the word "compensated" as used in section 165(a) of the I.R.C. is "covered." This construction is supported by legislative history[17] and by an analysis of Tax Court[18] and other judicial precedents,[19] as well as by analogies to well-settled constructions of other sections of the I.R.C.[20] As this Case Comment illustrates, it appears that the Tax Court in *Hills v. Commissioner*[21] declined to follow the doctrine of stare decisis.[22] Finally, this Case Comment discusses the Tax Court's fairness argument[23] and other income tax policies.

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12. *Id.* at 488.
13. Train, *Insurance: What You Need—And Don't Need,* FORBES, Sept. 28, 1981, at 192.
14. *Id.* at 193.
15. I.R.C. § 162(a) (1978).
16. I.R.C. § 262 (1978); Treas. Reg. § 1.262-1(b) (1958).
17. *See* J. SEIDMAN, SEIDMAN'S LEGISLATIVE HISTORY OF FEDERAL INCOME TAX LAWS (1938—1861), at 1018 (1938).
18. Miller v. Commissioner, 41 T.C.M. (CCH) 528 (1980), *vacated,* 42 T.C.M. (CCH) 665 (1981); Jewell v. Commissioner, 69 T.C. 791 (1978); Morgan v. Commissioner, 37 T.C.M. (CCH) 524 (1978); Axelrod v. Commissioner, 56 T.C. 248 (1971); Gale v. Commissioner, 41 T.C. 269 (1963); Coastal Terminals, Inc. v. Commissioner, 25 T.C. 1053 (1956); Henry Kraft Mercantile Co. v. Commissioner, 14 T.C.M. (CCH) 833 (1955); Brown v. Commissioner, 23 T.C. 156 (1954); Whitney v. Commissioner, 13 T.C. 897 (1949); Licht v. Commissioner, 37 B.T.A. 1096 (1938); Allied Furriers Corp. v. Commissioner, 24 B.T.A. 457 (1931).
19. Alison v. United States, 344 U.S. 167 (1952); Boehm v. Commissioner, 326 U.S. 287 (1945); Kentucky Utils. Co. v. Glenn, 394 F.2d 631 (6th Cir. 1968), *aff'g* 250 F. Supp. 265 (W.D. Ky. 1965); Commissioner v. Harwick, 184 F.2d 835 (5th Cir. 1950); Cahn v. Commissioner, 92 F.2d 674 (9th Cir. 1937), *rev'g* 33 B.T.A. 783 (1935); Commissioner v. Highway Trailer Co., 72 F.2d 913 (7th Cir. 1934); Waxler Towing Co. v. United States, 510 F. Supp. 297 (W.D. Tenn. 1980); Bartlett v. United States, 397 F. Supp. 216 (D. Md. 1975).
20. I.R.C. §§ 61 (1967), 162, 166, 213 (1978). *See infra* text accompanying notes 152–84.
21. 76 T.C. 484 (1981).
22. *See* H. BLACK, LAW OF JUDICIAL PRECEDENTS 203–18 (1912).
23. 76 T.C. 484, 488 (1981).

II. LEGISLATIVE HISTORY OF "COMPENSATED FOR BY INSURANCE"

The legislative history of section 165(a) is scant[24] and offers no definitive solution to the controversy at issue in *Hills*. The phrase "not compensated for by insurance" first appeared in the Revenue Act of 1894.[25] That Act was declared unconstitutional,[26] but identical language later reappeared and has remained the same. The original version by the House Ways and Means Committee referred to "losses actually sustained during the year . . . and not covered by insurance or otherwise, and compensated for."[27] The final version reported by the Senate Finance Committee read "losses actually sustained during the year . . . and not compensated for by insurance or otherwise."[28] Since the Finance Committee published no reports,[29] the reason for the change is a matter of speculation.

In *Hills* the Tax Court reasonably inferred that the revision was intended to eliminate a redundancy.[30] The court then said: "[A]ll losses compensated by insurance are also [necessarily] covered by insurance,"[31] but "the converse, *i.e.*, that all losses covered by insurance are also compensated for, is not necessarily true."[32] The court reasoned that since "compensated" encompasses "covered," the Finance Committee deleted "covered" and allowed "compensated" to stand for both coverage and payment.

However, the court ignored an alternative argument, also based on a redundancy theory, that would produce a different result. It might be that the Committee decided that "compensated" and "covered" were identical in meaning—that both denoted the concept of the availability of reimbursement. The Committee therefore chose just one word, "compensated," to stand for that concept in the final version, since the use of both words would be redundant in the tautological sense.

Another possible explanation for the change from "covered" to "compensated" avoids the problem with the redundancy theory. Instead of viewing the State Finance Committee's version as a mere substitution of the word "compensated" for "covered," one might view it as a rejection of the House's attempt to set up a two-step test. Under the original House version, to qualify for the loss deduction the casualty had to be "not covered by insurance . . . *and* compensated for."[33] If the taxpayer failed either prong of the test, that is, if he had insurance coverage or received compensation, then

24. J. SEIDMAN, SEIDMAN'S LEGISLATIVE HISTORY OF FEDERAL INCOME TAX LAWS (1938—1861), at 1018 (1938).

25. Pub. L. No. 227, ch. 349, § 28, 28 Stat. 509 (1894) (current version at I.R.C. § 165(a) (1978)).

26. Pollock v. Farmers' Loan & Trust Co., 157 U.S. 429 (1895).

27. J. SEIDMAN, SEIDMAN'S LEGISLATIVE HISTORY OF FEDERAL INCOME TAX LAWS (1938—1861), at 1018 (1938).

28. *Id.*

29. Hills v. Commissioner, 76 T.C. 484, 487 n.5 (1981).

30. *Id.* at 487.

31. *Id.*

32. *Id.*

33. J. SEIDMAN, SEIDMAN'S LEGISLATIVE HISTORY OF FEDERAL INCOME TAX LAWS (1938—1861), at 1018 (1938) (emphasis added).

the taxpayer could not take a deduction.[34] Since all losses "compensated" by insurance are "covered" by insurance, "covered" added nothing to the construction; therefore, the Senate simply dropped the first prong of the test, resulting in the existing "compensated for" language.[35]

A second weakness in the Tax Court's construction, as the four-judge dissenting opinion pointed out,[36] is the majority's statement that it is "obvious" that a "covered" loss is not necessarily a "compensated" loss. This begs the question because the "covered" loss will be "compensated" unless the taxpayer chooses not to accept reimbursement.[37] The majority's reasoning is correct given the assumption that "compensated" means "paid." However, this reasoning begs the question in another sense because the very issue the court attempted to settle through an analysis of legislative history is whether "compensated" means "paid."

A third problem with the majority's analysis is its use of the Treasury regulations to support the view that "compensated" means "paid."[38] One regulation states that "any loss actually sustained during the taxable year and not made good by insurance or some other form of compensation shall be allowed as a deduction subject to any provision of the internal revenue laws which prohibits or limits the amount of the deduction."[39] In *Hills* the Tax Court focused on the words "not made good by" and concluded that this phrase implied actual receipt of compensation.[40] Whether or not this is so, the loss must be "actually sustained during the taxable year." The question that must be answered is whether a loss is sustained when insurance coverage exists and the insurer has not denied liability during the taxable year.[41] In addition, the loss deduction is "subject to" the limitations of other provisions,[42] which prohibit the deduction in *Hills*.[43]

The regulation states that "[i]n determining the amount of loss actually

34. *But see* Tripp & Vogel, *Unreimbursed Insured Casualty Losses After* Hills, 60 TAXES 154 (1982). The authors maintain that under the original House version a loss covered by insurance would still be deductible "unless [the] taxpayer was directly compensated or reimbursed." *Id.* at 155. Apparently, the authors are interpreting the "and" that connects the "covered" clause and the "compensated" clause as a disjunctive "or." No reason is given for this departure from the usual statutory construction. For example, see United States v. Fisk, 70 U.S. 445 (1866); Schafer v. Helvering, 83 F.2d 317 (D.C. Cir.), *aff'd*, 299 U.S. 171 (1936); Seeley v. Helvering, 77 F.2d 323 (2d Cir. 1935); and R. DICKERSON, THE FUNDAMENTALS OF LEGAL DRAFTING 76–85 (1965).

35. J. SEIDMAN, SEIDMAN'S LEGISLATIVE HISTORY OF FEDERAL INCOME TAX LAWS (1938—1861), at 1018 (1938). Alternatively, the Senate Finance Committee could have dropped "compensated for" and kept the "covered by" language. Probably, the Committee never envisioned that an individual would not claim his insurance proceeds. The early courts apparently never did either, for they talked about losses being "covered" by insurance. *See infra* text accompanying notes 126–46.

36. 76 T.C. 484, 493 (1981) (Sterrett, J., dissenting).

37. *Id.*

38. *Id.* at 487–88.

39. Treas. Reg. § 1.165-1(a) (1960).

40. 76 T.C. 484, 487–88 (1981).

41. *See infra* text accompanying notes 126–46.

42. Treas. Reg. § 1.165-1(a) (1960).

43. *See infra* text accompanying notes 152–84.

sustained for purposes of section 165(a), proper adjustment shall be made for any salvage value and for insurance or other compensation received."[44] The word "received," which the Tax Court stressed,[45] can be read as modifying only "other compensation," and not "insurance." More important, this regulation is only concerned with the amount of the loss to be deducted. The allowance of the loss is determined by the regulations quoted in the preceding paragraph.

Finally, the court resorted to *Wester's Dictionary* to support its interpretation that "compensated" means "paid."[46] There is support for this approach.[47] For example, the Supreme Court has said that "the words of statutes—including revenue acts—should be interpreted where possible in their ordinary, everyday senses."[48] But other meanings of "to compensate" are "to weigh one thing against another" or "to counterbalance."[49] In this case the very thing to be weighed against the taxpayers' casualty loss is their insurance coverage. This weighing or balancing occurs at two levels. First, the insurance policy can be balanced against the loss to see if the type of loss in question is covered by the policy. Second, the amount of the loss can be balanced against the specific provisions of the insurance policy to see how much of the loss will be paid. The result of the balancing process is the compensation. Since the coverage balanced or equaled the loss in *Hills*, the taxpayers can be regarded as compensated.

This analysis illustrates that there are other meanings of the word "compensate" besides "pay" and that a different meaning produces a different result when applied to the issue in *Hills*. Reliance on *Webster's Dictionary*, though having some persuasive appeal, cannot be substituted for judicial

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44. Treas. Reg. § 1.165-1(c)(4) (1960).

45. 76 T.C. 484, 488 (1981).

46. *Id.* at 487 & n.3.

47. In South Jersey Sand Co. v. Commissioner, 30 T.C. 360 (1958), the Tax Court referred to *Webster's New International Dictionary* and the *Encyclopedia Britannica* in distinguishing between "sand" and "quartzite" for purposes of applying the proper depletion rates. *But see* Cabell v. Markham, 148 F.2d 737 (2d Cir. 1945). Judge Learned Hand warned:

> [T]he decisions are legion in which [the courts] have refused to be bound by the letter, when it frustrates the patent purpose of the whole statute. . . . [I]t is one of the surest indexes of a mature and developed jurisprudence not to make a fortress out of the dictionary; but to remember that statutes always have some purpose or object to accomplish.

Id. at 739.

48. Crane v. Commissioner, 331 U.S. 1, 6 (1947). *See also* Old Colony R.R. v. Commissioner, 284 U.S. 552 (1932):

> The rule which should be applied is established by many decisions. "The legislature must be presumed to use words in their known and ordinary signification." . . . "The popular or received import of words furnishes the general rule for the interpretation of public laws." . . . "[T]he plain, obvious and rational meaning of a statute is always to be preferred to any curious, narrow, hidden sense that nothing but the exigency of a hard case and the ingenuity and study of an acute and powerful intellect would discover." This rule is applied to taxing acts.

Id. at 560 (citations omitted). *But see* Malat v. Ruddell, 383 U.S. 569 (1966) (per curiam). "Departure from a literal reading of statutory language may, on occasion, be indicated by relevant internal evidence of the statute itself and necessary in order to effect the legislative purpose." *Id.* at 571–72.

49. WEBSTER'S NEW WORLD DICTIONARY 289 (2d college ed. 1980).

precedents and principles of law when determining legal constructions of words and phrases in the Internal Revenue Code.[50]

III. Judicial Interpretation

A. *Cases Considered by the Majority in* Hills

The court in *Hills* considered several cases, but rejected them for various reasons. Even though these cases technically are not binding precedents upon the Tax Court (because they represent authority in circuits other than the Fifth Circuit), they dealt with the issue in controversy, and the reasons for their rejection by the *Hills* court seem weak.

In *Kentucky Utilities Co. v. Glenn*[51] the taxpayer did not file an insurance claim for accidental damage to a steam generator because it feared losing its insurance coverage and wanted to maintain good business relations with its supplier, Westinghouse, against which the insurer had a right to subrogation.[52] The district court disallowed the deduction because the accident was covered by the insurance policy,[53] and the insurer had neither denied[54] nor disputed[55] its liability. Hence, the court concluded, the loss failed to qualify as "not compensated for by insurance or otherwise."[56] The Court of Appeals for the Sixth Circuit[57] affirmed because the loss "was not an 'uninsured loss.'"[58]

In *Bartlett v. United States*[59] the district court rejected the taxpayer's argument that "compensated" means "paid."[60] Moreover, the court accepted the Government's position that since the casualty loss was "covered" by insurance, the taxpayer's economic hardship was due to his voluntary choice not to seek reimbursement,[61] and not to any "sudden, . . . physical forces outside of the taxpayer's control," as required by section 165(c).[62]

On facts similar to those in *Hills*, the Tax Court in *Miller v. Commissioner*[63] denied the taxpayer a casualty deduction for a loss "covered" by

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50. See, *e.g.*, United States v. Correll, 389 U.S. 299, 304 n.16 (1967), which states in reference to the meaning of "away from home" in I.R.C. § 162(a)(2): "More than a dictionary is thus required to understand the provision here involved, and no appeal to the 'plain language' of the section can obviate the need for further statutory construction."

51. 250 F. Supp. 265 (W.D. Ky. 1965).

52. *Id.* at 269–71.

53. *Id.* at 270.

54. *Id.*

55. *Id.* at 271.

56. *Id.* The language of I.R.C. § 23(f) (1940), applied in *Kentucky Utilities*, is identical to the language in I.R.C. § 165(a) (1978).

57. Kentucky Utils. Co. v. Glenn, 394 F.2d 631 (6th Cir. 1968).

58. *Id.* at 633.

59. 397 F. Supp. 216 (D. Md. 1975).

60. *Id.* at 218.

61. *Id.*

62. *Id.*

63. 41 T.C.M. (CCH) 528 (1980), *vacated*, 42 T.C.M. (CCH) 665 (1981), *appeal docketed*, No. 81–1717 (6th Cir. Nov. 10, 1981).

insurance, since the court was bound by *Kentucky Utilities* pursuant to the rule established in *Golsen v. Commissioner*[64] (both *Miller* and *Kentucky Utilities* were brought in the Sixth Circuit).[65] After *Hills* was decided, Miller filed a motion to revise, and the Tax Court vacated its earlier decision. The court allowed Miller the deduction, citing *Hills* as authority, since *Miller* was then deemed distinguishable from *Kentucky Utilities*.[66]

Finally, although *Morgan v. Commissioner*[67] was also appealable to the Sixth Circuit, the court did not rely on *Kentucky Utilities* alone nor state that it was following the *Golsen* rule. Rather, the Tax Court held that "compensated" means "covered" and cited *Axelrod v. Commissioner*[68] as authority.[69]

With respect to *Kentucky Utilities*, the *Hills* court admitted that an insured loss is equivalent to one "covered" by insurance,[70] but added that this "is not the statutory language before us."[71] The implication of the *Kentucky Utilities* holding is quite clear, however. Because the loss was not an "uninsured loss,"[72] by affirming the district court's view that it was not a loss "not compensated for by insurance or otherwise"[73] the Sixth Circuit equated "insured" with "compensated." Therefore, if "insured" is equivalent to "covered," then *Kentucky Utilities* stands for the proposition that "covered" is equivalent to "compensated."

In *Hills* the Tax Court simply concluded that *Kentucky Utilities* was distinguishable, without revealing the process through which it reached its conclusion.[74] Some potential distinguishing factors follow. First, the loss in *Kentucky Utilities* was a business loss that the taxpayer attempted to deduct under section 165(c)(1), whereas in *Hills* the taxpayers suffered a theft loss and sought to come under section 165(c)(3). Congress could allow more favorable tax treatment for personal losses than for business losses, yet under the I.R.C. both subsections 165(c)(1) and 165(c)(3) are subject to the general requirement that for the loss to be deductible it must not be "compensated for by insurance or otherwise."[75]

Second, the taxpayer in *Kentucky Utilities* had two sources of reimbursement: the insurance company under the policy and Westinghouse under

64. 54 T.C. 742 (1970), *aff'd*, 445 F.2d 985 (10th Cir.), *cert. denied*, 404 U.S. 940 (1971). The court stated: "[I]t is our best judgment that better judicial administration requires us to follow a Court of Appeals decision which is squarely in point where appeal from our decision lies to that Court of Appeals." *Id.* at 757.

65. Miller v. Commissioner, 41 T.C.M. (CCH) 528, 530 (1980).

66. Miller v. Commissioner, 42 T.C.M. (CCH) 665 (1981).

67. 37 T.C.M. (CCH) 524 (1978).

68. 56 T.C. 248 (1971).

69. Morgan v. Commissioner, 37 T.C.M. (CCH) 524, 529 (1978).

70. Hills v. Commissioner, 76 T.C. 484, 490 n.7 (1981).

71. *Id.*

72. Kentucky Utils. Co. v. Glenn, 394 F.2d 631, 633 (6th Cir. 1968).

73. Kentucky Utils. Co. v. Glenn, 250 F. Supp. 265, 271 (W.D. Ky. 1965), *aff'd*, 394 F.2d 631 (6th Cir. 1968).

74. 76 T.C. 484, 490 (1981).

75. I.R.C. § 165(a) (1978).

its warranty. The Hillses also had two sources of recoupment: the insurance company and the thief. The difference between the two situations is that Westinghouse was a responsible concern with sufficient funds to pay for the loss, whereas the identity of the thief was unknown. The difference may make the taxpayer in *Kentucky Utilities* more blameworthy for not seeking reimbursement, or may give Congress a basis upon which it can create a policy to be more lenient with taxpayers like the Hillses. As stated above, however, this is not the law. The taxpayer in *Kentucky Utilities* suffered a loss that was covered by insurance and failed for personal reasons[76] to file a claim. This is exactly the situation in *Hills*.

In *Bartlett* the court raised another issue. The loss was due to the taxpayer's voluntary choice not to seek reimbursement.[77] Under this view there never was a casualty under section 165(c). Hence, there is no need to decide whether "compensated" means "covered" for purposes of section 165(a).[78] In *Hills* the court simply stated that it disagreed with this position.[79]

At the time *Hills* was decided the first opinion in *Miller* was not binding on the *Hills* court by virtue of the *Golsen* rule since Georgia is not in the Sixth Circuit. However, the first *Miller* opinion supports the argument that *Kentucky Utilities* is not distinguishable from *Hills*, since in the first *Miller* opinion, on facts similar to those in *Hills*, the court felt bound by *Kentucky Utilities*. Furthermore, the *Hills* court itself would seem to have said as much when it characterized the first *Miller* opinion as "abid[ing] by the rule announced in *Kentucky Utilities*."[80] Consequently, it appears that the Tax Court in *Hills* said that *Miller* was not distinguishable from *Kentucky Utilities*. The same court, after *Hills*, said in the second *Miller* opinion that *Miller* is virtually identical to *Hills*.[81] Therefore, *Hills* must also be indistinguishable from *Kentucky Utilities*. Apparently, the Tax Court changed its mind, because in the second *Miller* opinion it held that *Kentucky Utilities* was distinguishable from *Miller* for the same reasons it was distinguishable from *Hills*.[82] However, these reasons were never disclosed in *Hills*.

With respect to *Morgan*, the *Hills* court reasoned that since *Morgan* relied on a view contained only in the concurring opinion of Judge Quealy in

76. Kentucky Utils. Co. v. Glenn, 250 F. Supp. 265, 270 (W.D. Ky. 1965), *aff'd* 394 F.2d 631 (6th Cir. 1968). *Accord* Messenger Corp. v. Smith, 136 F.2d 172 (7th Cir. 1943). The debtor went bankrupt and the bankrupt estate paid five cents on the dollar. The taxpayer-creditor did not file a claim. The Seventh Circuit held that the taxpayer had a "duty to reduce its loss." Accordingly, the taxpayer's deductible loss was reduced by the amount that it could have received from the debtor, if it had filed a claim. *Id.* at 174.

77. Bartlett v. United States, 397 F. Supp. 216, 218 (D. Md. 1975).

78. Another way of looking at the *Hills* situation is the following. When a taxpayer elects not to file a claim and demand the insurance proceeds to which he is entitled because he fears his policy will be cancelled, he in essence elects to pay more for insurance coverage in the future. This windfall to the insurer in substance represents additional premiums. Insurance premiums are not deductible for an individual taxpayer as a personal, living, or family expense under § 262. Brief for Appellant at 15, Miller v. Commissioner, 42 T.C.M. (CCH) 665 (1981), *appeal docketed*, No. 81–1717 (6th Cir. Nov. 10, 1981).

79. 76 T.C. 484, 491 (1981).

80. *Id.* at 490 n.7.

81. Miller v. Commissioner, 42 T.C.M. (CCH) 665, 667 (1981).

82. *Id.*

Axelrod, the *Hills* court was not bound by *Morgan*, and the statements in *Morgan* offered only "limited guidance toward the resolution of the instant dispute."[83] The *Hills* court ignored *Morgan's* holding that "compensated" means "covered."[84] This is so whether *Axelrod* ever existed. *Morgan* was the Tax Court precedent to be applied, not *Axelrod.*

The majority in *Axelrod* never reached the issue of the proper meaning of "not compensated for by insurance or otherwise" in section 165(a).[85] Since there was no evidence establishing the amount of the loss,[86] the deduction was disallowed on that ground.[87]

Judges Quealy and Fay discussed the more interesting issues in their concurrences. In *Hills* the Commissioner took the position of Judge Quealy,[88] and the taxpayers that of Judge Fay.[89]

Judge Quealy's view, and that of the Commissioner in *Hills*,[90] was as follows: "Any economic disadvantage which [the taxpayer] may have sustained was not as a result of any casualty loss not being compensated for by insurance but rather was as a result of his choosing not to accept the funds available in compensation for any casualty loss."[91]

On the other hand, Judge Fay reasoned:

> The insured individual is frequently compelled to forego the desirable benefits of his insurance coverage in order to avert the otherwise inevitable cancellation of his policy or prohibitive increase of his insurance rates. Under these circumstances, such an individual is for all practical purposes without insurance, having been forced to assume the risk of loss in order to assure his continued coverage, and should be so treated.[92]

Even if Judge Fay's reasoning is the preferred view, the taxpayers in *Hills* failed to demonstrate that their situation fell within that rationale.[93] They did not show that they were "compelled to forego" insurance reimbursement to avoid "inevitable cancellation" of their policy or a "prohibitive increase" in their premium rate.[94] The taxpayers argued that "frequency of claims is a prime reason for cancellation of policies by insurance companies."[95] However, the findings of fact indicated that the three previous claims were

83. Hills v. Commissioner, 76 T.C. 484, 491 n.8 (1981).

84. Morgan v. Commissioner, 37 T.C.M. (CCH) 524, 529 (1978). See also Waxler Towing Co. v. United States, 510 F. Supp. 297, 299–300 (W.D. Tenn. 1980), which characterized *Bartlett*, *Kentucky Utilities*, and *Morgan* as standing for the proposition that "compensated" means "covered."

85. Axelrod v. Commissioner, 56 T.C. 248, 256 (1971).

86. *Id.* at 257.

87. *Id.* at 258.

88. *Id.* at 260–63 (Quealy, J., concurring).

89. *Id.* at 259–60 (Fay, J., concurring).

90. Hills v. Commissioner, 76 T.C. 484, 486 (1981).

91. Axelrod v. Commissioner, 56 T.C. 248, 261 (1971) (Quealy, J., concurring).

92. *Id.* at 260 (Fay, J., concurring). Furthermore, he adds that to hold the "contrary view is to discriminate against persons carrying insurance." *Id.* at 259. The fairness argument is discussed *infra* in text accompanying notes 185–205.

93. Reply Brief for Respondent at 3.

94. *Id.*

95. Brief for Petitioners at 2.

spaced over a six-year period at two- and four-year intervals, which the Government contended were not frequent.[96] The fourth theft occurred two years after the last claim.[97] The taxpayers "were reluctant to file a small theft claim and jeopardize the fire insurance coverage on the house."[98] Their fear was based on a general familiarity with the insurance industry rather than on specific warnings or other information that their policy would be cancelled if they made that fourth claim.[99] Furthermore, "They have not shown they sought, and were denied, alternatives to their homeowners coverage such as an increased deductible amount for theft loss or separate fire coverage."[100] The facts therefore seem to indicate that the taxpayers in *Hills* were not "compelled" to act as they did,[101] nor was cancellation of their policy "inevitable."[102]

Although none of the cases cited thus far was binding precedent upon the court in *Hills* and, therefore, "should not preclude a fresh consideration of this issue,"[103] three troublesome Tax Court opinions are directly on point and indicate that the issue is far from "fresh."[104]

B. *Three Tax Court Precedents Overlooked by the* Hills *Court*

The court in *Hills* apparently overlooked three important Tax Court cases. In *Whitney v. Commissioner*[105] the taxpayer-trustee made a payment in settlement of a suit against an employee, a truck driver, who struck and fatally injured a third party.[106] As a result, the taxpayer-trustee claimed a casualty

96. Brief for Respondent at 3.

97. *Id.* at 4.

98. Brief for Petitioners at 2.

99. Reply Brief for Respondent at 4.

100. *Id.*

101. If the taxpayers really thought that a fourth theft claim would jeopardize their fire insurance, they should have cancelled their theft coverage after the third claim in 1974 (or at least raised the deductible) instead of continuing to pay premiums for theft coverage if they never intended to make another theft claim.

102. In the second *Miller* opinion the Tax Court vacated its earlier decision and allowed the deduction pursuant to *Hills*, noting that Miller had a stronger basis for his fear of cancellation than did the Hillses because the insurance company actually gave notice that it would terminate all of Miller's insurance policies on their next renewal dates. Miller's broker persuaded the insurer to retain the existing policies in exchange for a higher deductible provision. The broker then advised Miller not to make any more claims, other than for catastrophic loss, or else the policies would be cancelled. 42 T.C.M. (CCH) 665, 666–67 (1981).

Several facts are worth stressing. First, it was the broker, not the insurance company, who warned Miller not to make any more claims. Second, even when the insurance company had previously threatened to cancel Miller's policies, the broker intervened and the policies were renewed with a higher deductible. These facts indicate that Miller actually had a weaker basis for his fear of cancellation than did the Hillses. Miller had already faced the threat of cancellation and had overcome it. The Hillses had never had that experience. As a result, it cannot be maintained that the cancellation of Miller's policies was inevitable.

103. Hills v. Commissioner, 76 T.C. 484, 490 (1981); *see also* Axelrod v. Commissioner, 56 T.C. 248, 259 (1971) (Fay, J., concurring).

104. The Internal Revenue Service in Rev. Rul. 141, 1978-1 C.B. 58, stated that it will follow *Bartlett*, *Kentucky Utilities*, and Judge Quealy's concurring opinion in *Axelrod*. Although this public statement did not appear until 1978, the Service had taken this position earlier by its actions in two very old cases, which are discussed later in this Case Comment: H.D. Lee Mercantile Co. v. Commissioner, 79 F.2d 391 (10th Cir. 1935), and Kurtz v. Commissioner, 8 B.T.A. 679 (1927).

105. 13 T.C. 897 (1949).

106. *Id.* at 898–99.

loss deduction pursuant to the predecessor of section 165(c)(3).[107] In his brief the taxpayer argued[108] that the loss should be allowed either as a trade or business loss[109] or as a loss in a transaction entered into for profit.[110] The Tax Court held that it did not need to decide[111] which type of loss it was because, in either event, to be deductible the loss had to "be one that is 'not compensated for by insurance or otherwise.'"[112] Under the law of Massachusetts a trustee required to answer in damages for the negligence of an employee has a right to indemnify himself from trust assets for any payments so made.[113] The taxpayer-trustee was not at fault in *Whitney*, and the trust contained sufficient assets to reimburse him.[114] The burden of proof was on the taxpayer to show that he was unable to recoup his loss.[115] As the Tax Court stressed:

> Losses to be deductible under the revenue laws, must be actual, realized losses, and in any case where there is a reasonable ground for reimbursement the taxpayer must seek redress and may not secure a loss deduction until he establishes that no recovery may be had. "It is a startling proposition that a taxpayer may, for reasons of his own, decline to enforce a valid claim against a responsible concern and then assert that he has sustained a business loss which the Government should share."[116]

In *Hills* the taxpayers did not suggest that their insurer was not a "responsible concern." The taxpayers themselves conceded that "reimbursement for their loss could probably have been received from the insurance company had a claim been filed."[117] Thus the Hillses had a "reasonable ground for reimbursement." They did not prove an inability to recoup their loss. Consequently, since the Hillses did not claim reimbursement from their

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107. I.R.C. § 23(e)(3) (1940) (current version at I.R.C. § 165(c)(3) (1978)). The pertinent parts of § 23 are the following:

§ 23 DEDUCTION FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

. . . .

(e) LOSSES BY INDIVIDUALS.

In the case of an individual, losses sustained during the taxable year and not compensated for by insurance or otherwise—

(1) if incurred in trade or business; or

(2) if incurred in any transaction entered into for profit, though not connected with the trade or business; or

(3) of property not connected with the trade or business, if the loss arises from fires, storms, shipwreck, or other casualty, or from theft.

108. 13 T.C. 897, 899 (1949).

109. I.R.C. § 23(e)(1) (1940) (current version at I.R.C. § 165(c)(1) (1978)).

110. *Id.* at (e)(2) (current version at § 165(c)(2)).

111. 13 T.C. 897, 899 (1949).

112. *Id.* at 900.

113. *Id.*

114. *Id.* at 901.

115. *Id.*

116. *Id.* (quoting M.D. Lee Mercantile Co. v. Commissioner 79 F.2d 391, 393 (10th Cir. 1935)).

117. Brief for Petitioners at 2.

insurer, under *Whitney* they would not be deemed to have sustained a loss that was "not compensated for by insurance or otherwise."[118]

In *Henry Kraft Mercantile Co. v. Commissioner*[119] the taxpayer's employee embezzled approximately $13,000. The taxpayer first discovered the embezzlement in 1950. At that time the taxpayer had an indemnity bond of $10,000. In addition, the employee delivered to the taxpayer in 1950 a $4,000 second mortgage on his home as security for the amount embezzled. The taxpayer took a $13,000 loss deduction on its 1950 income tax return and finally settled with its insurer in 1954 for $5,800.[120] The Tax Court specifically rejected the taxpayer's plea that the court "interpret the word 'compensated' . . . to mean 'recouped by the corporation or paid to it by way of restitution or indemnification.'"[121] The court added: "We have been cited to no cases where the word has been so construed, nor have we found any."[122] The *Kraft Mercantile* court concluded that since the loss was "covered" by the second mortgage and an indemnity bond and the insurer had not denied liability in the year the loss was discovered, the taxpayer did not sustain a loss in 1950 that was "not compensated for by insurance or otherwise."[123]

In *Jewell v. Commissioner*,[124] when discounting the applicability of *Kentucky Utilities* and *Bartlett* to the facts before it, the Tax Court said:

> These cases hold that a taxpayer is not entitled to a deduction for a casualty loss when the casualty was covered by insurance even though he chose not to make a claim for reimbursement under his insurance policy. The philosophy of these cases is that the taxpayer's loss was not from the casualty but from his deliberate action in not seeking to recover from the insurance company when in fact the loss was "compensated" for by insurance.[125]

Given this characterization and the facts of *Hills*, it is fair to say that the *Jewell* court would not deem *Kentucky Utilities* distinguishable from *Hills*.

C. *The Reasonable Prospect of Recovery Cases*

A line of cases dealing with "the very troublesome question as to the year in which the taxpayer should be allowed to take a deduction"[126] supports the principle stated in the regulations that when a reasonable prospect of recovery exists, no casualty loss deduction is allowed "until it can be ascertained with

118. I.R.C. § 165(a) (1978). In Stephenson v. Commissioner, 13 B.T.A. 311 (1928), the Board of Tax Appeals interpreted the identical language in the predecessor to § 165. The court held that no loss deduction was allowed because the taxpayers had not availed themselves of any remedy against the bank that sold them certain securities. Since the taxpayers had recourse against the bank and the bank was not insolvent, no loss was sustained. *Id.* at 320–21.

119. 14 T.C.M. (CCH) 833 (1955).

120. *Id.* at 833–34.

121. *Id.* at 835.

122. *Id.*

123. *Id.* On these facts the taxpayer should have received a $3200 deduction in 1954. *See infra* text accompanying notes 126–39.

124. 69 T.C. 791 (1978). *See infra* text accompanying notes 159–67.

125. 69 T.C. 791, 800–01 (1978).

126. Commissioner v. Highway Trailer Co., 72 F.2d 913, 913 (7th Cir. 1934).

reasonable certainty whether or not such reimbursement will be received."[127] Although the proper year of deduction was not the issue in *Hills*, these cases are helpful in resolving the issue by showing that "compensated" means "covered." In *Gale v. Commissioner*[128] the Tax Court said:

> [I]n determining whether the loss was "compensated for by insurance" [these cases] have applied a test of the reasonableness of a taxpayer's prospects of recovery of insurance proceeds, to determine in some cases that the loss was deductible in the year the claim for compensation was settled, . . . and in other cases that the loss was deductible in the year the casualty occurred.[129]

A reasonable prospect of recovery exists when a taxpayer has a bona fide claim for recoupment with a substantial possibility of success. The court applies this objective standard to determine the reasonable expectation as of the close of the taxable year for which the deduction is claimed. Consequently, the standard is applied by foresight using only the facts that are reasonably foreseeable as of the close of the particular year. Hence, future settlements and judicial actions will not be controlling if there is no reasonable prospect of recovery in the year the deduction is claimed.[130]

In *Allied Furriers Corp. v. Commissioner*[131] the Board of Tax Appeals held that if a casualty is covered by insurance or otherwise, no loss deduction is allowed in the year of casualty; rather, the deduction, if any, is allowed in the year of settlement.[132]

In *Licht v. Commissioner*[133] the taxpayer suffered a fire in 1931 that was "covered" by insurance. The New York Board of Fire Underwriters held hearings extending through 1931. The taxpayer sued the insurer in 1932 and a settlement was reached in 1933.[134] The court held that, given no evidence that the insurer denied liability in 1931,[135] the casualty was "compensated for by insurance" in 1931, and the loss was not sustained until 1933 upon termination of recovery proceedings when the loss deduction was allowed.[136]

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127. Treas. Reg. § 1.165-1(d)(2)(i) (1960); Commissioner v. Harwick, 184 F.2d 835 (5th Cir. 1950); Cahn v. Commissioner, 92 F.2d 674 (9th Cir. 1937); Commissioner v. Highway Trailer Co., 72 F.2d 913 (7th Cir. 1934); Gale v. Commissioner, 41 T.C. 269 (1963); Coastal Terminals, Inc. v. Commissioner, 25 T.C. 1053 (1956); Brown v. Commissioner, 23 T.C. 156 (1954); Licht v. Commissioner, 37 B.T.A. 1096 (1938); Allied Furriers Corp. v. Commissioner, 24 B.T.A. 457 (1931); Kurtz v. Commissioner, 8 B.T.A. 679 (1927).

128. 41 T.C. 269 (1963).

129. *Id.* at 275 (citations omitted).

130. Ramsay Scarlett & Co. v. Commissioner, 61 T.C. 795, 811 (1974).

131. 24 B.T.A. 457 (1931).

132. *Id.* at 459. *See also* Commissioner v. Harwick, 184 F.2d 835 (5th Cir. 1950).

133. 37 B.T.A. 1096 (1938).

134. *Id.* at 1099.

135. Although denial of liability by the insurer is itself not conclusive in determining the reasonableness of the prospects of recovery, it is a factor to be considered. Gale v. Commissioner, 41 T.C. 269, 276 (1963). When the insurer denies liability on the ground that the loss was not even covered by the policy, the courts have concluded that there was no reasonable prospect of recovery and have held the loss deductible in the year of casualty. Cahn v. Commissioner, 92 F.2d 674 (9th Cir. 1937); Coastal Terminals, Inc. v. Commissioner, 25 T.C. 1053 (1956). Similar results have been reached when the amount of damage was in excess of insurance coverage. Commissioner v. Highway Trailer Co., 72 F.2d 913 (7th Cir. 1934); Brown v. Commissioner, 23 T.C. 156 (1954).

136. 37 B.T.A. 1096, 1101 (1938).

These cases allowed the deduction in the year of settlement because the taxpayer had previously had a "tenable claim against his insurer,"[137] that is, a reasonable prospect of recovery.[138] They support the position that the insured taxpayer's loss was "compensated for" at the time of the casualty.[139]

Taken together, *Allied Furriers* and *Licht* stand for the proposition that if a casualty is covered by insurance, there is a reasonable prospect of recovery.[140] In addition, if there is a reasonable prospect of recovery, the loss is "compensated" for by insurance.[141] Therefore, if a casualty is "covered" by insurance, it is "compensated" for by insurance.

Kurtz v. Commissioner[142] supports this conclusion. There the taxpayer suffered a fire in 1921 that was "covered" by insurance, and he received partial reimbursement in 1922 and the remainder in 1923.[143] The taxpayer wanted to deduct the full amount of the loss in 1921 and report the insurance reimbursement as income in the years 1922 and 1923 when actually received.[144] The Commissioner applied the total amount of the insurance coverage against the fire loss in 1921 and disallowed the deduction.[145] The Board of Tax Appeals agreed with the Commissioner and held that "[t]he [taxpayer] was compensated by insurance for the total loss sustained in the year 1921. The insurance due [the taxpayer] for the loss sustained, accrued in the year 1921 and was properly applied in that year against the amount of the loss by fire."[146] By holding that the taxpayer was "compensated" in 1921, the Board of Tax Appeals essentially equated "compensated" with "covered" because in 1921 the taxpaper had received no money by way of reimbursement for the loss. All the taxpayer possessed in 1921 was the insurance coverage.

Finally, the Tax Court in *Hills* argued that if, in the litigation context, the Treasury regulations consider "settlement," "adjudication," and "abandonment" as proper determinants of the reasonable prospect of recovery,[147] then practical considerations also should be relevant in the insurance context to determine whether the taxpayer's "interests would be better served by never asserting his recovery rights."[148] However, these same regulations also state: "When a taxpayer claims that the taxable year in which a loss is sustained is fixed by his abandonment of the claim for reimbursement, he must be able to produce objective evidence of his having abandoned the claim, such as

137. Coastal Terminals, Inc. v. Commissioner, 25 T.C. 1053, 1056 (1956).
138. Licht v. Commissioner, 37 B.T.A. 1096, 1100 (1938).
139. Coastal Terminals, Inc. v. Commissioner, 25 T.C. 1053, 1056 (1956).
140. *See also* Gleason, *Tax Aspects of Insurance Recoveries for Casualty Losses*, 24 INST. ON FED. TAX'N 489, 506 n.75 (1966).
141. Licht v. Commissioner, 37 B.T.A. 1096, 1100 (1938).
142. 8 B.T.A. 679 (1927).
143. *Id.* at 684.
144. *Id.* at 682.
145. *Id.*
146. *Id.* at 684.
147. Treas. Reg. § 1.165-1(d)(2)(i) (1960).
148. 76 T.C. 484, 489 (1981).

the execution of a release."[149] In *Hills* there was no signed release, no accord and satisfaction, and presumably, the time for making the claim under the insurance policy had not expired before the taxable year in question ended. Therefore, the Hillses had not legally abandoned anything.

The Tax Court's view of abandonment in *Hills*, moreover, may miss the point of the regulations. The litigation context presumes the prior existence of a claim. The opposing party's denial of liability is the reason for the suit to enforce that claim. In *Hills* no claim was filed by the taxpayers,[150] and the insurer did not deny liability.[151] There was nothing under the regulations for the taxpayers to abandon. Thus, these regulations do not apply to a situation similar to that in *Hills*.

IV. Analogies to Other Code Sections

The Supreme Court has stated that "[a]ll acts of the legislature should be so construed, if practicable, that one section will not defeat or destroy another, but explain and support it,"[152] and the Board of Tax Appeals has said that since taxation is such a practical matter, the revenue laws "must be construed as a whole."[153] By reference to other sections of the I.R.C., it is evident that internal consistency requires that "compensated" means "covered" and that the taxpayer should not be permitted to forego claiming his insurance reimbursement and take an income tax deduction instead.[154]

In *M.D. Lee Mercantile Co. v. Commissioner*[155] the taxpayer ordered and paid for 133,000 yards of cloth. The taxpayer, demanding credit, claimed the cloth was not up to standard and returned it to the seller. Negotiations failed. After seven years the taxpayer determined the account to be uncollectable and deducted the cost of the returned cloth on its income tax return.[156] The taxpayer argued that it had a loss "not compensated for by insurance or otherwise," or alternatively, that it had a worthless debt under section 166. The court found neither a loss nor a bad debt because "the defaulter was a large and responsible concern, amply able to respond for breaches of contract."[157] The court added: "It is a startling proposition that a taxpayer may, for reasons of his own, decline to enforce a valid claim against a responsible

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149. Treas. Reg. § 1.165-1(d)(2)(i) (1960).

150. 76 T.C. 484, 485 (1981).

151. *Id.* at 492 (Sterrett, J., dissenting).

152. Bernier v. Bernier, 147 U.S. 242, 246 (1893).

153. Brons Hotel, Inc. v. Commissioner, 34 B.T.A. 376, 381 (1936).

154. *See* United States v. Olympic Radio & Television, Inc., 349 U.S. 232 (1955). The Supreme Court considered the "internal symmetry and consistency" of the I.R.C. and decided that to be "faithful to the statutory scheme," the words "paid or accrued" should have the same meaning in different parts of the Code. *Id.* at 236. *See also* Amtorg Trading Corp. v. United States, 23 F. Supp. 715 (S.D.N.Y. 1938). The court held that when a tax statute is "ambiguous or doubtful," other sections of the act that are "somewhat analogous in principle" are "entitled to great weight" in interpreting the ambiguous statute. *Id.* at 719.

155. 79 F.2d 391 (10th Cir. 1935), *aff'g* 3 B.T.A.M. (P-H) 37 (1934).

156. *Id.* at 392.

157. *Id.*

concern and then assert that he has sustained a business loss which the government should share."[158]

In *Jewell v. Commissioner*[159] one issue was whether certain medical expenses were "compensated for by insurance or otherwise" under section 213(a).[160] The taxpayer paid the medical expenses of his parents with checks drawn on his personal account.[161] The Commissioner argued that since the names of both the taxpayer and his parents were on a second, joint account, in which his parents deposited their Social Security checks, pension checks, and interest income, the taxpayer was reimbursed for his medical expense payments.[162] The Tax Court held that if the taxpayer had a right to the funds in the joint account, he would have been reimbursed[163] for the medical payments.[164] The court also held that under Indiana property law the requisite donor intent was lacking. Therefore, the taxpayer had no current ownership rights to the funds in the joint account.[165] Hence, the taxpayer was not reimbursed and the deduction was allowed.[166]

When the Tax Court in *Jewell* equated "right to the funds" with reimbursement (that is, with compensation under section 213(a)), it consequently was not referring to actual payment received by the taxpayer. All the taxpayers had to do in *Hills* was assert their right against the insurer and receive their money. No substantive difference exists between these two situations. Thus there appears to be no reason to interpret the phrase "not compensated for by insurance or otherwise" one way for a casualty loss deduction and a different way for a medical expense deduction.[167] Under the *Jewell* rationale the taxpayers in *Hills* were "compensated by insurance or otherwise" and no deduction should be allowed to them.

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158. *Id.* at 393. This is the court's position whether the taxpayer's reasons stem from business considerations or from friendly motives. *Id. Accord* Roth Steel Tube Co. v. Commissioner, 620 F.2d 1176, 1181 (6th Cir. 1980); Southwestern Life Ins. Co. v. United States, 560 F.2d 627, 644 (5th Cir. 1977), *cert. denied*, 435 U.S. 995 (1978); Loewi v. Commissioner, 232 F.2d 621, 625 (7th Cir. 1956); Bratton v. Commissioner, 217 F.2d 486, 489 (6th Cir. 1954); Ligget's Estate v. Commissioner, 216 F.2d 548, 550 (10th Cir. 1954); O'Bryan Bros. v. Commissioner, 127 F.2d 645, 646 (6th Cir. 1942).

159. 69 T.C. 791 (1978).

160. *Id.* at 792.

161. *Id.* at 798.

162. *Id.* at 793, 798.

163. "Reimbursed" meaning "compensated for," not by insurance, but "otherwise" as contained in the clause in I.R.C. § 213(a) (1978).

164. 69 T.C. 791, 802 (1978).

165. *Id.* at 802–04.

166. *Id.* at 804.

167. There is a presumption that identical words used in different parts of the Code have the same meaning. Helvering v. Stockholms Enskilda Bank, 293 U.S. 84, 87 (1934). This presumption will yield to circumstances that clearly show a contrary meaning, such as when the words were employed with different legislative intent in different sections because the sections have different histories and purposes. *Id. Accord* Baker v. Commissioner, 205 F.2d 369 (2d Cir. 1953); Rohmer v. Commissioner, 153 F.2d 61, 65 (2d Cir. 1946); Estate of Cuddihy v. Commissioner, 32 T.C. 1171, 1176 (1959). Both the casualty loss deduction under § 165 and the medical expense deduction under § 213 are allowed because they are not normal costs of living; they are involuntary, and they may reduce the taxpayer's ability to pay tax. B. BITTKER & L. STONE, FEDERAL INCOME TAXATION 265 (5th ed. 1980). Since both sections have similar purposes, the presumption stands. Accordingly, the identical words, "not compensated for by insurance or otherwise," used in both sections should be given the same meaning.

In *Heidt v. Commissioner*[168] the taxpayer-employee used his personal automobile in connection with company business.[169] The employer had a general policy of reimbursement for such expenses,[170] but the taxpayer voluntarily gave up the reimbursement[171] he would have received had he filed a claim[172] because he wanted "to avoid possible criticism in dealing with his subordinates."[173] The court concluded that the auto expenses were not ordinary and necessary business expenses of the taxpayer under section 162(a) because there was no evidence that if the taxpayer had claimed reimbursement it would not have been granted.[174]

In *Hills* no evidence existed that the insurer would have denied reimbursement had the taxpayers filed a claim,[175] and like Heidt, the Hillses voluntarily gave up reimbursement for personal reasons.[176] Thus, the casualty loss deduction in *Hills* could be disallowed on the basis of the *Heidt* rationale as well.

In the dissenting opinion in *Hills* Judge Sterrett argued that "[j]ust as a taxpayer cannot avoid taxation by turning his back on income, a taxpayer should not be allowed a deduction because he has refused to accept reimbursement."[177] The assignment of income cases also stand for the principle that a taxpayer can have taxable income even though he actually receives no cash or property.[178] These cases have held that a taxpayer cannot avoid reporting gross income under section 61 simply by refusing to accept it, if the

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168. 274 F.2d 25 (7th Cir.), *aff'g* 18 T.C.M. (CCH) 149 (1959).

169. *Id.* at 26.

170. *Id.*

171. *Id.* at 28.

172. *Id.*

173. *Id.* at 27.

174. *Id.* at 28. *Accord* Coplon v. Commissioner, 277 F.2d 534 (6th Cir. 1960); Neal v. Commissioner, 41 T.C.M. (CCH) 1247 (1981); Fountain v. Commissioner, 59 T.C. 696 (1973); Phillips v. Commissioner, 32 T.C.M. (CCH) 255 (1973); Carter v. Commissioner, 51 T.C. 932 (1969); Stolk v. Commissioner, 40 T.C. 345 (1963); Krych v. Commissioner, 20 T.C.M. (CCH) 44 (1961); Rogers v. Commissioner, 18 T.C.M. (CCH) 866 (1959); Estate of McJunkin v. Commissioner, 25 T.C. 16 (1955); Kimball v. Commissioner, 14 T.C.M. (CCH) 1011 (1955); Podems v. Commissioner, 24 T.C. 21 (1955); Standard Oil Co. v. Commissioner, 7 T.C. 1310 (1946); Glendinning, McLeish & Co. v. Commissioner, 24 B.T.A. 518 (1931).

175. Hills v. Commissioner, 76 T.C. 484, 492 (1981) (Sterrett, J., dissenting).

176. *Id.* at 485. *But see* Tripp & Vogel, *Unreimbursed Insurance Casualty Losses After* Hills, 60 TAXES 154 (1982). The authors argue that an involuntary election by an employee not to claim reimbursement from his employer can result in a tax deduction. *Id.* at 159–60 n.34. They cite Phillips v. Commissioner, 32 T.C.M. (CCH) 225 (1973), as authority. In *Phillips* the taxpayer used his personal auto for company business, but did not claim reimbursement from his employer. The Commissioner contended that since it was the company policy to reimburse the taxpayer, no deduction was allowable because taxpayer had voluntarily given up his right to reimbursement. The Tax Court agreed with the Commissioner's legal principle but not with its application to the facts. It found that the company reimbursement policy was verbally countermanded by taxpayer's supervisor, who limited the amount of reimbursement. The taxpayer claimed and received reimbursement for the amount permitted. The Tax Court allowed the excess as a tax deduction, not because there was an involuntary relinquishment of a right to reimbursement, but because no such right existed. *Id.* at 258.

177. 76 T.C. 484, 492 (1981) (Sterrett, J., dissenting).

178. Taxable income is gross income reduced by certain allowable deductions. I.R.C. § 63 (1978). It can be compared to a coin: the deduction of expenses and losses and the inclusion of income items are flip sides of the same taxable income coin.

taxpayer has the power,[179] control,[180] right,[181] or means[182] to obtain that income from its source. The taxpayers in *Hills* had the power, control, right, and means to obtain reimbursement from their insurer. All they had to do was ask for it. They even conceded "that reimbursement . . . could probably have been received . . . had a claim been filed."[183] If having the power, control, right, or means to acquire income is as good as having that income, then having the power, control, right, or means to obtain reimbursement for a casualty loss should be as good as having that reimbursement, when that entitlement is subject only to the taxpayer's "unfettered command."[184]

V. Fairness and Tax Policy

The Tax Court in *Hills* reasoned that "[w]hen a taxpayer fails to pursue a right of insurance recovery, his economic loss is nonetheless sustained and a deduction should be allowed. To hold otherwise would unjustifiably advantage taxpayers who voluntarily decline insurance coverage."[185] In *Axelrod* Judge Fay said that to disallow the deduction to a taxpayer in a situation

179. Helvering v. Horst, 311 U.S. 112 (1940). The taxpayer detached some interest coupons from his negotiable bonds and delivered them to his son as a gift. The interest income was held taxable to the taxpayer-donor since he had the power to dispose of that income. *Id.* at 118. *See also* Mitchel v. Bowers, 15 F.2d 287 (2d Cir. 1926). The taxpayer entered into an agreement with his wife which provided that she would be entitled to one half of the income that was distributed to the taxpayer from Power, Son & Co. *Id.* at 288. Assuming the contract not to be a sham, the court held that since the taxpayer had the power to terminate the contract at will and resume title to the company profits, the absolute disposition of the income was within the taxpayer's power and all of the income should be taxed to him. *Id.* at 288–89.

180. Galt v. Commissioner, 216 F.2d 41 (7th Cir. 1954). The taxpayer leased his racetrack to a trotting association and subsequently assigned 20% of the rental income to each of three sons. *Id.* at 43. The taxpayer could not escape taxation on that 60% of the income because he had retained title to the property. *Id.* at 46. The income was taxed to the donor because he retained control of the source from which it flowed. *Id.* at 47. *Accord* Lum v. Commissioner, 147 F.2d 356 (3d Cir. 1945); Midwood Assocs. v. Commissioner, 115 F.2d 871 (2d Cir. 1940); Mitchel v. Commissioner, 27 B.T.A. 101 (1932). In Henson v. Commissioner, 174 F.2d 846 (5th Cir. 1949), the taxpayer made a bona fide gift of his business to his wife with no strings attached. She had the right to control the income of the company and, therefore, the income was taxed to the wife and not to the taxpayer-husband. *Id.* at 847. *Accord* Montgomery v. Commissioner, 230 F.2d 472 (5th Cir. 1956); Semmler v. Commissioner, 173 F.2d 218 (6th Cir. 1949) (per curiam). *See also* Brown v. Commissioner, 115 F.2d 337 (2d Cir. 1940). The taxpayer assigned his right to receive compensation for his legal services to a corporation he wholly owned. The compensation was held taxable to Brown because he did not part with control of the income. *Id.*

181. Duran v. Commissioner, 123 F.2d 324 (10th Cir. 1941). The taxpayer sold a high volume of life insurance for the New York Life Insurance Co. each year for 20 years and became entitled to monthly payments of approximately $480 for the rest of his life. The taxpayer assigned his future payments to his sister, but the court still held that those payments were taxable to him because he created the right to receive that income. *Id.* at 325–26. *Accord* Vance v. Commissioner, 14 T.C. 1168 (1950).

182. Commissioner v. O'Donnell, 90 F.2d 907 (9th Cir. 1937). The taxpayer sold stock in exchange for a one-third interest in the net profits derived from the development and operation of oil properties. *Id.* at 907. The court noted that mere intention to make a gift is not sufficient to create a gift. When the taxpayer delivered to the purchaser a letter directing it to make all future payments under the contract to his wife, however, he made a completed gift because he gave his wife the means of obtaining possession and control of his gift, which was tantamount to making a delivery of the corpus of the gift to his wife. *Id.* at 909.

183. Brief for Petitioners at 2.

184. McCauley v. Commissioner, 44 F.2d 919 (5th Cir. 1930).

185. 76 T.C. 484, 488 (1981).

similar to that in *Hills* "is to discriminate against persons carrying insurance, a result which I do not think was intended."[186]

Some commentators reason that the casualty deduction is allowed because the casualty loss is not a normal cost of living—it is involuntary and may reduce the taxpayer's ability to pay tax.[187] The Senate Finance Committee, stating its reasons for section 165, said that "casualty and theft losses will continue to be deductible . . . in those cases where they are sufficient in size to have a significant effect upon an individual's ability to pay Federal income taxes."[188] When a taxpayer has insurance coverage, his ability to pay taxes is not lessened. The insurance coverage supplies the necessary resources. No economic hardship exists.

This view is supported by the Supreme Court:

> [I]t is a general rule, without exception, in construing statutes, that effect must be given to all their provisions if such a construction is consistent with the general purposes of the act and the provisions are not necessarily conflicting. . . . When a provision admits of more than one construction, that one will be adopted which best serves to carry out the purposes of the act.[189]

Under the facts of *Hills*, if "compensated" means "paid" instead of "covered," the taxpayers would be allowed the casualty loss deduction under section 165(a). This would be contrary to the purpose of the provision, which is to give some relief to those individuals whose ability to pay income taxes is reduced. Since the insurance policy is an asset owned by the taxpayers and included in their net worth, which balances and offsets the loss, it prevents a reduction in their ability to pay income taxes. On the other hand, if "compensated" means "covered," section 165(a) would recognize the insurance coverage as compensation and disallow the deduction. This is consistent with the purpose of the provision since the ability to pay income taxes is not reduced and no relief is needed by the taxpayer. Therefore, the better construction of section 165(a) is to equate "compensated" with "covered." This is especially so when the above analysis is coupled with the judicial

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186. 56 T.C. 248, 259 (1971) (Fay, J., concurring). Judge Fay also stated, however, that "a taxpayer's failure to collect payment under an insurance policy may sometimes justify disallowance of a loss deduction." *Id.* at 260. Apparently he would prefer some sort of subjective test or case-by-case analysis. This approach would put a tremedous strain on adminstrative efficiency and would hamstring an already overburdened judiciary.

187. B. BITTKER & L. STONE, FEDERAL INCOME TAXATION 265 (5th ed. 1980). *See generally* 2 B. BITTKER, FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS ¶ 34.1 (1981).

188. S. REP. NO. 830, 88th Cong., 2d Sess. 57, *reprinted in* 1964 U.S. CODE CONG. & AD. NEWS 1673, 1730.

189. Bernier v. Bernier, 147 U.S. 242, 246 (1893). *See* Malat v. Ruddell, 383 U.S. 569 (1966) (per curiam). "Departure from a literal reading of statutory language may, on occasion, be indicated by relevant internal evidence of the statute itself and necessary in order to effect the legislative purpose." *Id.* at 571–72. *See also* Brons Hotel, Inc. v. Commissioner, 34 B.T.A. 376, 381 (1936) (a sensible construction of a statute is one that effectuates legislative intent); 1 J. MERTENS, THE LAW OF FEDERAL INCOME TAXATION § 3.04 (rev. ed. 1981). "The courts will . . . not hesitate to depart from a literal interpretation in order to reach the real consistent legislative intent. . . . The literal meaning of words cannot be insisted upon in resisting a tax provision so as to defeat its purpose." *Id.* (citations omitted).

precedents discussed earlier.[190] That this compelling statutory construction discriminates against taxpayers carrying insurance "may suggest that changes in the law are desirable. But if they are to be made, Congress must make them."[191]

"[T]axability depends upon the actual circumstances existing at the time of the [casualty]."[192] Congress did not intend to punish people who were inept prophets, who did not expect a casualty, or who were too poor to afford insurance.[193] It does not matter whether the taxpayers in *Hills* are treated differently from a taxpayer who does not have insurance. The I.R.C. does not concern itself with hindsight analysis,[194] that is, with what the taxpayers should have done before the event in question. Accordingly, the court should only look to see whether the taxpayer has insurance at the time of the casualty.

The view that a taxpayer should not have the choice to refuse his insurance proceeds and, instead, take a casualty loss deduction on his income tax return is supported by another long-standing policy of taxation. In *Burnet v. Sanford & Brooks Co.*[195] the Supreme Court stated:

> All the revenue acts which have been enacted since the adoption of the Sixteenth Amendment have uniformly assessed the tax on the basis of annual returns showing the net result of all the taxpayer's transactions during a fixed accounting period, either the calendar year, or, at the option of the taxpayer, the particular fiscal year which he may adopt.[196]

The taxpayers in *Hills* and *Miller*, in essence, were asking the court to look beyond the taxable year in question to an event (cancellation of the insurance policy) whose occurrence was speculative and to use that uncer-

190. *See supra* notes 51–184 and accompanying text.

191. United States v. Olympic Radio & Television, Inc., 349 U.S. 232, 236 (1955). "'[G]eneral equitable considerations' do not control the question of what deductions are permissible." *Id. See also supra* note 154 and accompanying text. In LaBelle Iron Works v. United States, 256 U.S. 377 (1921), the Supreme Court stated:

> The difficulty of adjusting any system of taxation so as to render it precisely equal in its bearing is proverbial, and such nicety is not even required of the States under the equal protection clause, much less of Congress under the more general requirement of due process of law in taxation. Of course it will be understood that Congress has very ample authority to adjust its income taxes according to its discretion. . . . Courts have no authority to pass upon the propriety of its measures.

Id. at 392–93. In Evans v. Gore, 253 U.S. 245 (1920), the Supreme Court indicated the extent to which the courts must defer to Congress regarding economic legislation, especially tax legislation:

> [F]or, as this court repeatedly has held, the power to tax carries with it "the power to embarrass and destroy"; may be applied to every object within its range "in such measure as Congress may determine"; enables that body "to select one calling and omit another, to tax one class of property and to forbear to tax another"; and may be applied in different ways to different objects so long as there is "geographical uniformity" in the duties, imposts and excises imposed.

Id. at 256.

192. Cold Metal Process Co. v. Commissioner, 247 F.2d 864, 872 (6th Cir. 1957).

193. "As for the casualty-loss deduction, its effect is not so much to compensate people whose well-being has been impaired as to compensate people who have lacked the foresight to insure." R. POSNER, ECONOMIC ANALYSIS OF LAW 378 (2d ed. 1977).

194. *See supra* note 130 and accompanying text. *See, e.g.*, Surasky v. United States, 325 F.2d 191, 194 (5th Cir. 1963). *See generally* Burnet v. Sanford & Brooks Co., 282 U.S. 359 (1931).

195. 282 U.S. 359 (1931).

196. *Id.* at 363.

tainty as a reason to allow a deduction in the current year. The Supreme Court has rejected the notion that a taxpayer can postpone "the assessment of the tax until the end of a lifetime, or for some other indefinite period, to ascertain more precisely whether the final outcome of the period, or of a given transaction, will be a gain or a loss."[197]

Consider the consequences of the taxpayer's request. Even if a claim is filed and payment received, the insurance policy may not be cancelled.[198] It appears that the taxpayer is proposing some sort of reasonable prospect of cancellation test instead of using the reasonable prospect of recovery test as required by the Treasury regulations[199] and the courts.[200] Even if the taxpayer could prove with reasonable certainty that the policy would be cancelled if a claim were filed, no economic loss exists by virtue of the cancellation until another casualty occurs. But another casualty may never occur. A second test would be needed: a reasonable prospect of another casualty.

The taxpayers in *Hills* and *Miller* asked the Tax Court to grant them a loss deduction for a casualty for which no insurance claim was filed, because the insurance policy may have been cancelled and another casualty may have occured to produce an economic detriment greater than their paying for the current small loss themselves. The taxpayers' actions may have made good business sense, but this double probability approach applied on a case-by-case determination would place a great burden on administrative and judicial efficiency. The reasonable prospect of recovery test by itself has produced many cases.[201] To apply two more levels of scrutiny would be too much to ask of an already overburdened judiciary. The court should only consider the facts and circumstances in existence at the close of the taxable year.[202] If the taxpayer does have insurance coverage, and a reasonable prospect of recovery does exist, then the taxpayer is compensated, with no deduction allowed in the year of the loss.[203] If the taxpayer has no insurance or other form of coverage, then the deduction should be allowed in the year of loss,[204] with reinstatement into income in future years if recoupment from other sources is obtained.[205]

VI. CONCLUSION

The original intent of Congress indicates that a casualty loss is not deductible under section 165(a) if it is covered by insurance. This intent is supported by the precedents that consider covered losses to be nondeductible. This is so

197. *Id.* at 365.
198. *See supra* note 102 and accompanying text.
199. Treas. Reg. § 1.165-1(d)(2) (1960).
200. *See supra* text accompanying notes 126–46.
201. *See id.*; 5 J. MERTENS, THE LAW OF FEDERAL INCOME TAXATION § 28.51 (rev. ed. 1980).
202. Ramsay Scarlett & Co. v. Commissioner, 61 T.C. 795, 811 (1974).
203. *See supra* text accompanying notes 126–41.
204. Commissioner v. Highway Trailer Co., 72 F.2d 913, 915 (7th Cir. 1934).
205. United States v. S.S. White Dental Mfg. Co., 274 U.S. 398, 403 (1927); Treas. Reg. §§ 1.111-1(a) (1956), 1.165-1(d)(2)(iii) (1960).

even though the statute uses the word "compensated." Hence, the courts implicitly equate "covered" with "compensated." Moreover, Tax Court precedent specifically rejects the interpretation that equates "compensated" with "paid." A line of cases dealing with the reasonable prospect of recovery issue looks to whether a loss is covered (by insurance or otherwise) to determine the proper year of deduction—denying the deduction in the year of casualty when such coverage exists.

Furthermore, precedents of the Tax Court and other courts with respect to not only section 165 but also other sections of the I.R.C. support the proposition that a taxpayer is not permitted to forego claiming insurance coverage or other reimbursement and as an alternative take an income tax deduction. This judicial interpretation is supported by the fairness concept of taxation, the purpose underlying the adoption of section 165, and long-standing income tax policy. As a result, the doctrine of stare decisis, applied to statutory law, mandates that *Hills* and *Miller* not be followed.

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